

# Hedging the IRS—A Policy Justification for Excluding Liability and Insurance Proceeds

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*Uncertainty about tax results is an ever-present obstacle to business transactions despite the extensive number of Internal Revenue Code sections and Treasury Regulations. Some insurance companies now provide an insurance product to protect taxpayers against adverse tax consequences from proposed transactions. Ironically, this new insurance product, labeled “tax insurance,” poses uncertain tax consequences itself. This Article argues that if the adverse tax consequences arise (that is, the taxpayer has additional tax liability) and the insurance company is contractually required to cover that liability, the tax insurance proceeds are not includable in the insured’s gross income. As part of the reasoning that underlies this conclusion concerning tax insurance, the Article examines and develops a novel approach that provides a tax policy justification for excluding general liability insurance proceeds from the insured’s income. The Article concludes that the same justification also applies to exclude tax insurance proceeds from the insured’s gross income. The Article also examines whether the premiums paid for tax insurance coverage are deductible business expenses. Finally, the Article examines the appropriate tax treatment of other types of tax indemnity arrangements.*

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## Introduction

Despite—or perhaps on account of—the incredibly complex nature of our tax laws, individuals and business organizations face uncertainty as to the tax results of many transactions. Congress and the Internal Revenue Service,<sup>1</sup> even if they so desired, could not set out rules in sufficient detail to provide certainty as to every possible transaction that may arise in the future.<sup>2</sup> Unless alleviated, this uncertainty will cause some taxpayers to avoid engaging in transactions that would otherwise benefit society or the economy, resulting in a deadweight loss. Thus, it is desirable to derive ways to eliminate or mitigate this uncertainty in order to avoid deterring financially and socially beneficial transactions.<sup>3</sup>

Taxpayers frequently are faced with a choice of either abandoning a project or proceeding with it and accepting the question of the tax liability as one of the risks of the venture. Insurance companies have seen this circumstance as presenting an opportunity for them to enter the market and provide a useful service. To that end, some companies now provide insurance to protect a taxpayer against adverse tax consequences from a proposed transaction.<sup>4</sup>

If an insured client does not receive the tax treatment for which he purchased insurance and thereby collects from the insurance company an

1 Hereinafter referred to as the "Service."

2 Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 343 (2005) ("One might surmise that the natural solution to the problem of tax law uncertainty would be for the government—either Congress or the Treasury Department—to clarify the law in advance so that such uncertainty does not exist. It simply is not possible, however, to eliminate substantive tax law uncertainty for every conceivable business transaction.").

3 *Id.* at 370-71 ("What this means is that legal risk is something that most people would pay to avoid, which in turn means that social welfare would be enhanced if legal risk could be reduced or eliminated at a cost less than what people are willing to pay to shed it.").

4 I refer to privately provided tax risk insurance as "tax insurance" throughout the Article although such products have also been given other names (e.g., tax liability insurance, tax indemnity insurance, and tax risk transactional insurance).

amount equal to the additional taxes he is required to pay the Service, what is the tax consequence of his receiving that payment? While the Service apparently has not yet challenged a taxpayer's treatment of tax insurance proceeds, one possible explanation for the absence of litigation is that taxpayers are voluntarily reporting it as income.<sup>5</sup> In any event, anyone considering the purchase of tax insurance will want to take into account the extent to which there is a risk that payments received pursuant to the policy will themselves be taxed.<sup>6</sup> The purpose of this Article is to examine that issue and several related topics.

Part I of this Article briefly explains and reviews the history of tax insurance and its predecessors. Part II examines the treatment of insurance proceeds received because of the damage or destruction suffered by an insured item of property<sup>7</sup> and also discusses the tax treatment of liability insurance.<sup>8</sup> In this Part, the Article will propose a policy justification for the tax law's treatment of the receipt of proceeds from property insurance and from liability insurance, including a discussion of *Clark v. Commissioner*<sup>9</sup> and its progeny. The treatment of those insurance proceeds constitutes the backdrop against which my analysis of the proper treatment of tax insurance rests.

Part III examines whether the proceeds of a tax insurance policy are to be taxed to the recipient and whether premiums paid for a tax policy are deductible. Part IV considers the proper tax treatment of payments made by a seller pursuant to a guaranty that the seller made as to how the buyer will be taxed in connection with the purchased item. Part V considers the proper tax treatment of payments received from a third party, such as a broker, who guaranteed a specific tax result to induce the taxpayer to invest in a venture. Finally, Part VI sets forth a summary of my conclusions.

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5 See *infra* Part I.B.

6 As described below, the parties have incorporated coverage for that risk by including in tax insurance contracts a gross-up provision to insulate the insured from any additional taxes that might be imposed because of the insurance payment.

7 The Article refers to this type of insurance as "property insurance."

8 In this Article, the term "liability insurance" refers to insurance that will satisfy a liability of the insured that might arise upon the occurrence or nonoccurrence of specified events. This Article does not discuss life insurance because the tax treatment of the receipt of life insurance proceeds invokes additional policy considerations that do not apply to tax insurance. For a brief discussion of the policy considerations involved in the taxation of life insurance, see Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645, 681-83 (2006).

9 40 B.T.A. 333 (1939), *acq. in result*, 1957-1 C.B. 4; see *infra* Part II.C.

## I. Tax Insurance—An Overview

### A. *Old Market for Insurance Against Tax Uncertainty*

Although tax insurance is a relatively recent phenomenon,<sup>10</sup> insuring against uncertainty in the tax law is not. Those arrangements that first came into use prior to the insurance companies' entrance into the field are sometimes referred to in this Article as "old market."<sup>11</sup> Old market techniques are still available. As detailed below, several options exist that differ in their degrees of coverage.

One means of eliminating tax result uncertainty is to have the government provide an opinion *ex ante* on what the tax results would be for a specific proposed transaction. In fact, the government provides this type of "insurance" by offering to issue private letter rulings about the tax treatment that will be applied to proposed transactions. The Service issues private letter rulings directly to a requesting taxpayer, thereby, "in effect, guaranteeing with some limitations a particular tax treatment for a particular transaction."<sup>12</sup> As discussed below,<sup>13</sup> it can be difficult to obtain timely rulings on proposed transactions.<sup>14</sup>

Another example of old market insurance is tax return preparers' provision of warranties for their clients. These warranties generally state that the preparer will indemnify the client for any interest and penalties caused by the preparer's mistake.<sup>15</sup> Thus, the risk of penalties and interest is shifted from the client to the preparer so long as the conditions of the warranty are met.<sup>16</sup> The Service has not yet demonstrated any concern over the granting of this type of warranty, presumably because it appears that such warranties do not

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10 See, e.g., Kenneth A. Gary, *New Opportunity for Tax Lawyers: Insuring Tax Transactions*, 104 TAX NOTES 26 (2004).

11 Professor Logue used the term "old market" to describe commercial options that were used before the advent of tax insurance to cover tax transaction risk. The term "new market" refers to third-party tax insurance. Logue, *supra* note 2, at 376, 387.

12 Logue, *supra* note 2, at 343. While the ruling applies only to the requesting taxpayer, private letter rulings must be open to the public. I.R.C. § 6110(a) (2008).

13 See *infra* note 32.

14 See, e.g., Rev. Proc. 2007-7, 2007-1 C.B. 228 ("A 'comfort' ruling will not be issued with respect to an issue that is clearly and adequately addressed by statute, regulations, decisions of a court, tax treaties, revenue rulings, or revenue procedures absent extraordinary circumstances (e.g., a request for a ruling required by a governmental regulatory authority in order to effectuate the transaction)."). Also, time constraints may make a request for a ruling impractical because of the time that elapses between the request and the receipt of the ruling.

15 Note that the preparer does not agree to cover the actual underpayment of the tax. Logue, *supra* note 2, at 377.

16 There is an issue as to whether this is truly a risk shift since the warranty covers only the amount of "damages" caused by the tax return preparer's error. That is, the tax return preparer is likely already at risk for amounts due on account of the preparer's mistakes. However, this warranty may shift the risk for amounts due on account of a tax return preparer's error that does not rise to the level of malpractice or negligence (and thus would not allow recovery under normal legal considerations).

increase the amount of noncompliance by taxpayers.<sup>17</sup> The proper tax treatment of payments made pursuant to such warranties is discussed in Part IV.

Warranties may also be provided to clients of tax advisors—that is, tax attorneys and accountants who may both advise clients on how to structure a transaction and provide an opinion on the tax consequences of a proposed transaction.<sup>18</sup> Unlike tax return preparer warranties, these warranties generally do not indemnify the client for any type of payment that the client ultimately is required to make to the Service. That is, they do not cover the actual underpayment itself, nor any interest or penalties that may be due. Instead, the warranty covers the payment made to the advisor for the specific advice. As Professor Logue has noted, these warranties “take the form of a money-back guarantee: if the particular issue on which the advisor gave an opinion ends up being challenged on audit and rejected by the Service and a court, the advisor agrees to refund some or all of the fees that were charged for the advice.”<sup>19</sup> The proper tax treatment of such refunds is discussed in Part IV.

Unmistakably, through two separate devices, the government has expressed its hostility to tax advisor warranty arrangements and has indicated the need for their oversight. First, Circular 230<sup>20</sup>—a collection of regulations published by the Service that contain rules “governing the recognition of attorneys, certified public accountants, enrolled agents, and other persons representing taxpayers before the Internal Revenue Service”<sup>21</sup>—specifically prohibits payment via “contingent fees” for work on an original tax return. “Contingent fees” include:

[A] fee arrangement in which the practitioner will reimburse the client for all or a portion of the client’s fee in the event that a position taken on a return or other filing is challenged by the Internal Revenue Service or is not sustained, whether

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17 Logue, *supra* note 2, at 380 (“[A]lthough the use of tax preparers may have some negative effects on taxpayer compliance (as well as some positive effects), there is no obvious compliance cost or benefit associated with the warranties per se. That is, the existence of these warranties probably does not by itself create an incentive for insured taxpayers to take overly aggressive positions on their tax returns.”). Since the warranties only cover amounts due because of the tax return preparer’s error, it is unlikely that they have any effect on the positions taken by taxpayers.

18 In his article, Professor Logue describes the difference between “tax advisors” and “tax return preparers”:

By “tax advisor” here I mean someone who advises a taxpayer regarding (a) how to structure a given transaction so as to minimize taxes, and then (b) how to report that transaction on the taxpayer’s return. The advisor therefore is providing expertise on the tax law as it applies to a particular situation and is involved in so-called tax planning. By “tax return preparer” I mean someone who fills out the tax return itself. Obviously, the preparer may give some legal advice on how to report certain issues; thus, the distinction does not always hold up. One can still usefully distinguish, however, between the H&R Blocks of the world and the lawyers and accountants that give more specialized transactional advice on specific issues, usually to corporate or wealthy individual taxpayers.

*Id.* at 382 n.82.

19 *Id.* at 383.

20 31 C.F.R. §§ 10.0-10.93 (2008).

21 *Id.* § 10.0 (2008).

pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.<sup>22</sup>

Second, the Treasury requires disclosure from every taxpayer who participates in certain transactions, labeled “reportable transactions.”<sup>23</sup> While “[t]he fact that a transaction is a reportable transaction shall not affect the legal determination of whether the taxpayer’s treatment of the transaction is proper,”<sup>24</sup> it is clear that the Service will subject reportable transactions to extra scrutiny. This reporting requirement will discourage the adoption of those transactions since no taxpayer desires to red-flag his return. One form of reportable transactions is “transactions with contractual protection.” This term is defined broadly enough to cover the situation where there is a potential refund should the Service disallow the promised tax results.<sup>25</sup>

As noted above, there does not appear to be any government hostility to tax preparer warranties.<sup>26</sup> Despite some similarities between the two types of warranties, the difference in governmental oversight appears justified because the nature of the markets for the two products is different. Tax return preparers generally deal with the completion and filing of basic tax returns, and the warranty itself, which covers only mistakes made by the preparer, does not appear to encourage abusive reporting. On the other hand, tax advisors sometimes sell sophisticated tax shelters, and contingent pricing may encourage more taxpayers to engage in those transactions. The problem of taxpayers attempting to play the audit lottery<sup>27</sup> is more severe in the tax advisor situation. Whether or not that distinction is valid, however, is not the focus of this Article. Instead, I will discuss the possible tax consequences that attend the adoption of such insurance provisions.

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22 *Id.* § 10.27(c)(1). Contingent fees are allowed in connection with advice or preparation of an amended return. *Id.* § 10.27(b)(2). The difference in treatment is justified because the Service is concerned with taxpayers and advisors betting on the audit lottery for aggressive positions. The term “audit lottery” refers to taking a questionable position on a tax return in the hope that the return will not be selected for audit. With amended returns, however, the Service is not concerned that the return will slip through the cracks and not be scrutinized for aggressive positions.

23 Treas. Reg. § 1.6011-4(a) (2008).

24 *Id.*

25 Treas. Reg. § 1.6011-4(b)(4) (2008) states:

A transaction with contractual protection is a transaction for which the taxpayer or a related party (as described in section 267(b) or 707(b)) has the right to a full or partial refund of fees (as described in paragraph (b)(4)(ii) of this section) if all or part of the intended tax consequences from the transaction are not sustained. A transaction with contractual protection also is a transaction for which fees (as described in paragraph (b)(4)(ii) of this section) are contingent on the taxpayer’s realization of tax benefits from the transaction. All the facts and circumstances relating to the transaction will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to the transaction have not designated as fees or any agreement to provide services without reasonable compensation.

26 Circular 230 does not address tax preparer warranties, and such provisions are not covered under the reportable transactions requirement.

27 *See supra* note 22, § 10.27(c)(1).

The final “old market” tax risk-shifting device is the standard tax indemnity agreement. These agreements are common in the sale and purchase of businesses, which routinely involve both tax and non-tax contingent liabilities that the contracting parties allocate as they see fit. Indemnification is sometimes provided by a broker who seeks to induce a prospective buyer to consummate a sale. Indemnification agreements are also used in certain divorce settlements. The Service has not indicated hostility to, or a need for oversight of, this type of indemnification “insurance.”<sup>28</sup>

#### B. *New Market—Tax Insurance*

The invention and increased popularity of tax insurance should not come as a surprise. An expert in the field estimated that approximately forty to fifty policies are issued each year, and over half of tax insurance applications are refused.<sup>29</sup> Tax insurance clients are primarily business entities, and the tax liability coverage is usually quite large.<sup>30</sup>

Tax insurance is a natural evolution from the old market of insurance options, especially as to tax indemnity agreements. Instead of shifting liability risks between contracting parties, such as a buyer, seller, or broker, tax insurance shifts the tax uncertainty risk as to the consequences of a transaction to a neutral third party for a fee.<sup>31</sup> Since it can be difficult or even impossible to get a private letter ruling from the Service, the market for tax insurance has expanded.<sup>32</sup>

28 Logue, *supra* note 2, at 385-87.

29 Telephone Interview with Roy Reynolds, Managing Partner, Risk Capital Partners (Sept. 19, 2008). The number of issued policies has remained steady over the past few years. However, because of the significant changes in accounting for income taxes found in Financial Accounting Standards Board Interpretation 48 (“FIN 48”), there is reason to believe that the number of tax insurance policies will rise. FIN 48 could greatly increase the disclosure by firms of risky tax positions. See Jennifer Blouin et al., *What Can We Learn about Uncertain Tax Benefits from FIN 48?*, 60 NAT’L TAX J. 521, 525 (2007) (“The most controversial aspect of FIN 48, from corporations’ point of view, is the requirement for detailed disclosure of the reserve for uncertain tax benefits. Disclosure requirements were substantially increased under FIN 48.”). This increase in disclosure may lead to an increased desire to reassure investors and shareholders that risky tax positions are covered by tax insurance. Telephone Interview with Roy Reynolds, *supra*.

30 One expert estimated the smallest insurance policy with which he was involved was a potential \$2.5 million liability. The largest policy covered a potential \$500 million tax liability. Telephone Interview with Roy Reynolds, *supra* note 29.

31 Logue, *supra* note 2, at 386. The mergers and acquisitions area is the primary source for tax insurance policies. In many cases, the insurance would be used in place of tax escrow accounts that buyers and sellers would otherwise set up as part of an acquisition or merger. Telephone Interview with Roy Reynolds, *supra* note 29.

32 The turnaround time for tax insurance can be as quick as one to two weeks. Gregory Taggart, *Take Me Out of the Ball Game*, BLOOMBERG WEALTH MANAGER, June 2005, at 37, 39. In comparison, in 2005 the Service instituted an “expedited” ruling program in which taxpayers with certain qualified issues could receive a ruling ten weeks from the Service’s receipt of the request. Rev. Proc. 2005-68, 2005-2 C.B. 694. The length of time is not, however, the only issue. The Service refuses to provide any ruling on a large number of proposed transactions. Rev. Proc. 2008-3, 2008-1 I.R.B. 110.

If a client seeks insurance that a proposed transaction will receive a specified tax treatment, the insurer will refer the request to a panel of tax experts who are employed by the insurer to evaluate the client's position.<sup>33</sup> The panel will then determine the likelihood of the client's receiving the desired tax treatment. Presumably, the insurance companies will be conservative in evaluating the probable tax consequences because their assets are at risk.<sup>34</sup> They will either refuse to provide insurance or will set the premium for it according to the panel's evaluation of the probability of an adverse tax result.

Private letter rulings are the closest analogy to the tax insurance product, but in the latter case the protection is provided by a third-party insurer instead of by the government.<sup>35</sup> In effect, by issuing a private letter ruling, the government assumes the taxpayer's risk of not having correctly predicted the tax consequences of a proposed transaction. Like most old market products, tax insurance contracts usually cover one specific transaction.<sup>36</sup> Generally, tax insurance indemnifies the insured for both the actual underpayment and for any interest and penalties due, subject to contractual limits and deductibles.

There is some question whether the government should be concerned about—and therefore regulate—the tax insurance market. Proponents of tax insurance (and nonregulation thereof) argue that since insurance companies will not insure high-risk transactions, tax insurance is beneficial to the government because an approval from insurance companies will signal a legitimate tax position and thereby lighten the Service's auditing responsibilities.<sup>37</sup> Indeed, it is plausible that insurance companies would be even more conservative in approving a transaction than the Service would be. While it is likely that tax insurance could lead unregulated taxpayers to take more aggressive tax positions since the liability for those positions has been shifted to a third party, the reporting of the transaction must obtain the approval of the insurer, who will have a strong financial reason to veto overly aggressive positions.<sup>38</sup> In effect, the insurer serves as a surrogate for the government in overseeing that the transaction is taxed properly.

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For example, the Service refuses to rule on whether a proposed nonrecognition corporate spin-off is done for a business purpose or meets the device test requirement of Internal Revenue Code § 355(a)(1)(B). Rev. Proc. 2003-48, 2003-2 C.B. 86. Sometimes, however, taxpayers seek tax insurance coverage even in instances where they also have private letter rulings from the Service. Telephone Interview with Roy Reynolds, *supra* note 29.

33 Taggart, *supra* note 32, at 40.

34 Gary, *supra* note 10, at 27.

35 Unlike private letter rulings, which cost a flat amount for each request (differentiated by the subject matter of the ruling), tax insurance premiums are variable and are based on the risk involved with the covered transaction.

36 The one old market exception is the tax preparer warranty, which covers the entire return.

37 The government has relied on a third-party verification of the bona fides of a transaction in other tax areas. See Kahn, *supra* note 8; see also Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695 (2007) (discussing the importance of third-party behavior and reporting for fostering tax compliance).

38 See Telephone Interview with Roy Reynolds, *supra* note 29 (stating that more than half of all tax insurance applications are rejected).

Initially, in temporary regulations, the government included transactions covered by tax insurance under “reportable transactions.”<sup>39</sup> After objections from the insurance industry, the government backed down: the final regulations do not include such transactions on the list of what must be disclosed.<sup>40</sup>

The benefits and costs of tax insurance (and whether a regulatory response is desirable) are not the focus of this Article.<sup>41</sup> This Article addresses the tax consequences to the insured should the insurance company end up paying on the insurance contract. An analysis of this issue has not yet been fully developed in any article.<sup>42</sup> Insurance companies have protected taxpayers from the risk of incurring a tax on the insurance payouts by providing a “gross-up” provision in the insurance contract so that the insurer will not only pay the covered liability but also gross-up the coverage amount to cover the taxes due on all its payments.<sup>43</sup> The function of this provision is to make the taxpayer whole on an after-tax basis. Obviously, this type of provision would not be necessary if it were settled that the insurance payment is nontaxable to the insured. Since the issue has not yet been formally resolved, insurance companies have offered to add protection from that risk to the tax insurance policies for an increased premium amount.

Before addressing the issue of the taxation of tax insurance proceeds, it is useful to review (1) the tax treatment of insurance proceeds received because of the damage suffered by an insured item of property; (2) the tax treatment of payments made pursuant to a liability insurance contract; and (3) the policy justifications for those treatments.

## II. Property and Liability Insurance

### A. *Tax Treatment of Receipt of Damages and Proceeds from Property or Liability Insurance*

If a tortfeasor reimburses a taxpayer for damage to the taxpayer’s property, the taxpayer includes the reimbursement in income only to the extent that the payment exceeds the taxpayer’s basis in the damaged property.<sup>44</sup> The

39 Logue, *supra* note 2, at 401.

40 Treas. Reg. § 1.6011-4(b) (2008).

41 For discussion of these benefits and costs, see Logue, *supra* note 2.

42 *Id.* at 388-89 n.92; see also Richard A. Wolfe, *Tax Indemnity Insurance: A Valuable and Evolving Tool for Managing Tax Risks*, 739 PLI/TAX 371, 425-34 (2006).

43 See Logue, *supra* note 2, at 388. Tax insurance policies are offered either with a gross-up provision or without. Apparently, most clients choose to buy the gross-up provision. The charge for the gross-up provision is applied at the same rate as the underlying liability. Thus, the insurance companies are not discounting the gross-up amount. Telephone Interview with Roy Reynolds, *supra* note 29.

44 See *Raytheon Prod. Corp. v. Comm’r*, 144 F.2d 110, 114 (1st Cir. 1944); BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF*

excess reimbursement is realized income, but the taxpayer may elect to defer the recognition of that amount if the taxpayer reinvests in similar property within a specified time period.<sup>45</sup>

Superficially, with respect to damaged personally-used property, the treatment of excluding the reimbursement to the extent of the property's basis might appear to be overly taxpayer-friendly.<sup>46</sup> If the taxpayer were not reimbursed by any party for damage to personally-used property, the taxpayer would be allowed to deduct the loss—up to the amount of the taxpayer's basis—under the casualty and theft loss provision.<sup>47</sup> However, that deduction is subject to several limitations that often prevent the taxpayer from deducting the full amount of his loss.<sup>48</sup> By excluding from income damages received up to the amount of the taxpayer's basis in the damaged property, the Internal Revenue Code<sup>49</sup> effectively allows the taxpayer a deduction equal to the full amount of the basis without limitation. What then is the justification for this treatment?

The justification for the exclusion of damages is similar to the justification for taxing the amount received on a voluntary sale of property only to the extent it exceeds the taxpayer's adjusted basis. While the tortfeasor does not actually purchase the property, the involuntary conversion of all or part of the property into cash is similar to a forced sale. On a sale, the amount received that does not exceed the taxpayer's basis is a return of capital, and so is not treated as income. The damages received from a tortfeasor that do not exceed the taxpayer's basis also are a return of capital<sup>50</sup>—that is, a return of the dollars

INDIVIDUALS ¶ 3.04 (3d ed. 2002); *see also* DOUGLAS A. KAHN & JEFFREY H. KAHN, *FEDERAL INCOME TAX 77-78* (5th ed. 2005). One exception to this rule is where the taxpayer previously was allowed a deduction for the loss and the tax benefit rule applied. KAHN & KAHN, *supra*, at 183-87. For purposes of this Article, I will assume that no deduction was claimed.

45 I.R.C. § 1033 (2000 & Supp. 2005).

46 *See, e.g.*, Daniel Halperin, *Valuing Personal Consumption: Cost Versus Value and the Impact of Insurance*, 1 FLA. TAX REV. 1, 29 (1992) (“Ultimately of course, it might seem unfair to include the recovery in income without allowing a deduction for the loss which the recovery reimburses. But this justification for the exclusion of recoveries appears inconsistent with no deduction for uninsured losses.”).

47 I.R.C. § 165(c)(3) (2000). These losses are sometimes referred to as “personal casualty loss[es].” I.R.C. § 165(h)(3) (2000). For a policy discussion of the personal casualty loss deduction, *see* Jeffrey H. Kahn, *Personal Deductions—A Tax “Ideal” or Just Another “Deal”?*, 2002 L. Rev. M.S.U.-D.C.L. 1.

48 The largest limitation on the deductibility of personal casualty losses is that a taxpayer's net personal casualty loss (the amount that the taxpayer's personal casualty losses exceed the taxpayer's personal casualty gains) is deductible only to the extent that such loss exceeds ten percent of the taxpayer's adjusted gross income. I.R.C. § 165(h)(2)(A) (2000). The deduction is also classified as an itemized deduction and therefore is subject to the limitations placed on that category. *See* I.R.C. § 67(b)(3) (2000).

49 Hereinafter referred to as the “Code.”

50 If the property is merely damaged, but not destroyed, the tax law is generous in utilizing all of the taxpayer's basis in the property instead of apportioning a percentage of the basis equal to the percentage of the value of the property that was lost. *Cf.* Treas. Reg. § 1.61-6(a) (2008) (if only a portion of property is sold, only a portion of the basis of the property is allocated to that sale). However, the current treatment is consistent with the treatment generally accorded in some analogous areas such as

invested in the property—and therefore the exclusion from income follows the traditional policy of not taxing such returns.<sup>51</sup> Note that for this purpose, it makes no difference whether the damages are paid by the tortfeasor directly or through liability insurance that the tortfeasor had purchased.

Should the tax result be any different if, instead of the tortfeasor's paying damages, the taxpayer is reimbursed by an insurance company that the taxpayer paid for coverage of the property that was lost or damaged due to casualty or theft? In other words, should income include the proceeds received from a property insurance policy? The established tax treatment of the insured, which I believe to be proper, is the same for the receipt of property insurance proceeds as the treatment of damages received from a tortfeasor. The amount received is excluded from income to the extent that the payment does not exceed the taxpayer's basis in the property. As with damages paid by a tortfeasor, any excess amount is income, subject to a taxpayer's election of nonrecognition to the extent that the taxpayer reinvests in similar property.<sup>52</sup>

As noted above, the tax treatment of a taxpayer who receives compensation for damaged property does not depend upon whether the amount is paid by the tortfeasor directly or by an insurance company through liability coverage. However, another issue concerns the tax treatment of the tortfeasor who has purchased liability insurance. Should the tortfeasor recognize income when the insurance company pays the damages? Despite the fact that the payment satisfies a liability of the tortfeasor, it does not cause the tortfeasor to realize any income.<sup>53</sup> The payment is made pursuant to a contract with the insured in which the risk of loss for damages caused by the insured was shifted to the insurer for a fee that reflects the dollar amount of that risk at the time that the shift took place.

Now, let us consider whether the exclusions described above are justified by tax policy.

### B. *Policy Justifications for Exclusion from Income*

Instead of treating the proceeds from property insurance as a payment on the property, the proceeds could be regarded as a payment pursuant to an aleatory contract in which the insured receives a greater amount of money than he paid the insurer. The loss of property could be regarded as merely the

bargain sales. Compare Treas. Reg. § 1.1001-1(c) (2008) (providing for no allocation of basis on a transfer that is in part a sale and in part a gift where the transferee is a private person), with I.R.C. § 1011(b) (2000) (requiring that basis be allocated on a transfer that is in part a sale and in part a gift where the transferee is a charitable organization).

51 See Kahn, *supra* note 8, at 659 (“The damages received are not income to the extent of the taxpayer's basis because the dollars received are treated as a replacement of the dollars the taxpayer is deemed to have invested in the property lost due to the casualty or theft.”).

52 I.R.C. § 1033 (2000 & Supp. 2005).

53 BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 3.08.

measuring device for determining the amount payable by the insured under the aleatory contract. The difference between what the insured paid the insurer for the coverage and the amount he receives would then be income to the insured. If this approach were adopted, the amount paid by the insured might well be restricted to the amount of the most recent premium he paid rather than the sum of all premiums paid on the policy. Premiums are not installment payments. Each premium purchases insurance for a specified period, and when that period expires, the insurance coverage purchased with the premium expires as well.<sup>54</sup> So, only the last premium paid by the insured is attributable to the insurance proceeds that the insured receives.

What then is the justification for not taxing the insured on the excess he receives over the amount he paid for the coverage?<sup>55</sup> One factor favoring exclusion is the presence of a policy to encourage the purchase of property and liability insurance, or, at least, a policy that does not discourage the purchase of property or liability insurance. If property or liability insurance proceeds were taxable to the insured, the incentive to purchase those policies would be reduced. Either the insured would net less than the amount of loss he insured, or the insured would have to pay a higher premium to purchase a gross-up provision in the policy to pay for the additional tax liability. Congress might conclude that there are societal benefits to having persons purchase property or liability insurance so that risks are pooled and thereby shared by a larger number of persons. In addition, Congress might conclude that it is desirable to reduce the risks incurred by a single person from a transaction in order not to deter that person from engaging in socially useful endeavors. While Congress and the Service may very well favor these policies, and they may have had some influence on the resolution of how to treat insurance proceeds, there is a principled justification for the current tax treatment that does not depend upon the presence of some programmatic goal.<sup>56</sup> To understand that principle better, consider the well-established doctrine of anticipation of income.

54 See Joseph M. Dodge, *The Netting of Costs Against Income Receipts (Including Damage Recoveries) Produced by Such Costs, Without Barring Congress from Disallowing Such Costs*, 27 VA. TAX REV. 297, 340 (2007).

55 Some commentators have described this exception as “perplexing.” See, e.g., BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 3.08[1][c].

56 Professor Daniel Halperin theorized that the value of the insurance should be viewed ex ante, that is, before we know whether the insured will need the use of the insurance. As Professor Halperin stated:

Under this approach the value of insurance or a dealer warranty could be said to be the price or premium charged, whether or not the taxpayer recovered on the policy. The purchaser who insures has merely acquired a more ‘reliable,’ and hence a more expensive product, no different than if she had purchased a better quality model.

Halperin, *supra* note 46, at 29. Some commentators have analogized this to an “excludable bargain purchase.” BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 3.08[1][c].

However, I do not find this justification compelling. The same argument could be used in many areas where we still end up taxing the proceeds. For example, assume *A* and *B* put one chip down on different numbers on a roulette wheel. Each party has a 1/38 chance of having the roulette ball land on their number. Thus, ex ante, each party has purchased the same chance of winning. The ball lands on *A*'s

If a person attempts to give away a right to income, the doctrine of anticipatory assignment of income can come into play. When applicable, this doctrine requires that the transferred income be taxed to the transferor when the income is received or accrued by the transferee. For example, if *A*, who owns stock of the *X* Corporation, transfers to *B* for no consideration the right to the dividends on *A*'s stock in *X* Corporation for the next five years, the dividends that are paid to *B* will be taxed as income to *A*.<sup>57</sup>

If instead *A* sold to *B* for a fair price the right to dividends for the next five years, *A* would have ordinary income for the amount paid by *B*,<sup>58</sup> but the dividends that *B* received from *X* would be taxed to *B* rather than to *A*.<sup>59</sup> This treatment is sometimes referred to as the “anticipation of income” doctrine; it is distinguishable from the anticipatory assignment of income doctrine, which can apply when the assignor of income receives no or inadequate consideration for the assignment. Of course, for each dividend that he receives, *B* can take a deduction for a portion of the amount that *B* paid.<sup>60</sup> The point is that when *B* buys the right to *A*'s income in a bona fide, arm's-length transaction, the right to the income passes from *A* to *B*, and *A* is no longer subject to tax on that income. In effect, *A* is taxed on the present value of the assigned income as reflected by the amount paid to *A* for the right to that income, and the amount received by *B* in excess of that present value is taxed to *B*. *A* is thereby able to shift to *B* the incidence of the tax on the amount of assigned income that accrues in *B*'s hands.

What significance does the anticipation of income doctrine have for the proper treatment of property insurance proceeds? When an insured purchases property insurance coverage, he pays the insurer to assume a risk that otherwise is borne by the insured. The premium paid reflects the current dollar value<sup>61</sup> of the risk that is insured plus a fee for the services provided by the insurer. However, the premium will not equal the sum of these items, because the

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number and thus *A* wins (and *B* loses). No one would argue that *A* should not be taxable on that amount because he received what he paid for (that is, a chance to win).

57 See, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940) (holding that when a taxpayer gifted interest coupons to his son but retained the underlying bond, the interest paid to his son was included in the father's gross income); see also BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 34.03[3]; KAHN & KAHN, *supra* note 44, at 723-24.

58 See, e.g., *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (holding that the assignment for consideration of a payment right which extends over a period less than the life of the property results in the receipt of ordinary income by the assignor); see also KAHN & KAHN, *supra* note 44, at 732; Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 299 (1961).

59 KAHN & KAHN, *supra* note 44, at 730-31.

60 *B* would take depreciation deductions each year for the amortization of the amount *B* paid to *A*. See *Early v. Comm'r*, 445 F.2d 166 (5th Cir. 1971); *Gist v. United States*, 423 F.2d 1118 (9th Cir. 1970).

61 There is no term to refer to the dollar amount that a risk represents. I use the term “value” to refer to that dollar amount, but I recognize that it is an awkward choice. I will use the term “value” in that manner throughout this Article.

insurer will discount the value of the risk to reflect the fact that the insurer's payment of the insured amount will be deductible for federal income tax purposes. If the loss that was insured takes place, the amount of that loss in excess of the value of the risk at the time that the premium was paid<sup>62</sup> reflects the increase in the value of the risk while in the hands of the insurer. As a consequence of that contract, the insurer is the person *primarily* responsible for any losses that are covered by the insurance contract. The transfer of the risk to the insurer is comparable to the transfer of the right to income in an anticipation of income transaction.

The insured's payment of the premium does not mean that the insured bears that amount of a loss that may subsequently arise. The insured bears the loss of the premium payment regardless of whether the risk materializes. While the amount of the premium is determined in part by the current value of the risk, the premium does not represent a prepayment of a loss that may subsequently occur. Illustrating that the premium is not a prepayment of a loss, note that if the insured property is destroyed, the insured may be taxed on the receipt of the insurance proceeds to the extent that the proceeds exceed the basis of the property. No allowance is made for the premium paid by the insured. So the loss that is incurred on the damage, destruction, or theft of the property is a loss to the insurer, who has been paid to assume the primary risk of that loss.

In contrast to the anticipation of income situation in which the assignor has no further interest in the assigned income, the insured continues to bear a risk for a loss incurred by the insured property, since the insured continues to own that property. However, after the assignment, the insurer is primarily liable for the loss, and the insured is only secondarily liable if the insurer defaults. The transfer of primary liability for a loss to the insurer is sufficiently similar to a purchased right to income to justify comparable treatment by the tax law.

Why then does the insured realize income when the insurance proceeds exceed his basis in the property? As previously noted, the shifting of the primary risk from the insured to the insurer means that the insured did not receive the insurance proceeds as recompense for a loss that the insured suffered. The loss was suffered by the insurer who had undertaken that risk for a fee. But, since the insurer does not own the property, the only way that it can bear the loss is to pay the owner of the property that amount of the loss. If the insurer did not pay that amount to the owner, it would be the owner who bore the risk of the loss, which would be contrary to their contractual arrangement. Since the payment is made to the insured to fulfill the contract that the insurer will bear the loss, the receipt by the insured is a return of the value of the property that was lost. How then should that replacement of the lost value be treated? To the extent that the amount received by the insured does not exceed

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62 The portion of the premium that represents a payment for the service performed by the insurer does not represent the present value of any part of the risk borne by the insured.

his basis, it constitutes a return of the insured's capital and so is not income. Any excess received by the insured is income.

Putting it another way, the insured's payment to the insurer for the latter to assume a property risk that the insured otherwise would bear is analogous to *A*'s selling to *B* the right to dividends for a period of time. Just as *B* acquired the right to the dividends so that *A* was not taxed thereon when they were paid, so did the insurer acquire the risk of loss so that the insured is not the party who should be deemed to have incurred that loss when the property is damaged or stolen. The party who ultimately is required to bear the risk of loss is the one who should be deemed to have incurred that loss in the absence of a default. In that regard, consider the treatment in partnership taxation, where the regulations determine which partner bears the economic risk of loss by deeming the person liable for the loss, assuming all contractual obligations are honored, to bear the risk.<sup>63</sup>

This same reasoning also applies to the justification for excluding liability payments from an insured's income.<sup>64</sup> The purchase of liability insurance by the insured shifts the risk of loss from the insured to the insurer. When the insured causes an injury, the insured is liable to the injured parties for the damage he causes. But the ultimate liability for these damages lies with the insurer who had agreed to accept that risk. It is irrelevant to the tax treatment of those payments that the insured is secondarily liable for these damage payments if the insurer fails to fulfill its contract. The fact that the insured could be required to pay the victims of his actions does not make the insured the primary obligor, since the insured would be entitled to reimbursement from the insurer if he pays. For tax purposes, the primary obligor should be deemed the person who ultimately bears the loss.<sup>65</sup>

Now, let us consider liability insurance. Unlike the taxation of property insurance when the insurance proceeds exceed the insured's basis, an insured's benefit from an insurer's payment under a liability insurance contract does not cause the insured to recognize income. The insurer's payment, whether made as a reimbursement to the insured or as a direct payment to the injured party, is a satisfaction of a liability that had been contractually shifted to the insurer. Just as *A*, in the example above, is not taxed on dividend income the right to which had been purchased by *B*, so should an insured not be taxed on the insurer's satisfaction of a liability that is primarily that of the insurer. Consider

63 See Treas. Reg. § 1.752-2(b)(1), (b)(3), (f)(ex. 4) (2008).

64 Commentators have struggled to come up with a policy justification for this treatment. See BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 3.08[1][c] ("Yet another, more perplexing exception to the *Old Colony* rule is the universally accepted exclusion by a taxpayer-tortfeasor of liability insurance proceeds paid to a claimant plaintiff by the insurance company on the taxpayer's behalf. This treatment is sanctioned by practice, even though there is no statutory provision or administrative or judicial authority on point.")

65 Cf. Treas. Reg. § 1.752-2(b)(1), (b)(3), (f)(ex. 4) (2008).

an analogous circumstance where an employee's negligence causes harm to a third party who recovers damages from the employer. Even though the employee also was liable for the injury, the employer's payment is not income to the employee.<sup>66</sup>

Another way of looking at liability insurance is that the insurance proceeds replace dollars that the insured either paid or can be deemed to have paid to the victims. The replacement of dollars is equivalent to the replacement of basis, and so does not cause the insured to realize any income.<sup>67</sup> Indeed, the justification for excluding from income amounts received (1) on the sale of an item, (2) as damages, or (3) as property insurance, to the extent these amounts do not exceed basis, is that they are a return of the cash that the owner had invested in the property. When the item replaced is the cash itself, it is obvious that it is not taxable to the recipient.<sup>68</sup>

### C. *Clark and Its Progeny*

Similar reasoning was used in the seminal case, *Clark v. Commissioner*,<sup>69</sup> a 1939 Board of Tax Appeals<sup>70</sup> case. The Clarks hired an "experienced tax counsel" to prepare their income tax returns for 1932. The tax counsel advised the Clarks to file a joint return for 1932 instead of two separate individual returns. In 1934, the Clarks were audited by the Service and the revenue agent estimated that the Clarks owed approximately \$34,500 in additional taxes. The underpayment was due to an error of the tax counsel and, after this error was pointed out, it was determined that if the Clarks had filed separate individual returns, they would have owed almost \$20,000 less in taxes. In recognition of his error (and as it was too late to alter the filing status of the Clarks), the tax

66 While the employer has a right to seek reimbursement from the employee, such rights are hardly ever exercised.

67 See, e.g., Dodge, *supra* note 54, at 338-43. Professor Dodge states that the "only plausible explanation [for excluding the insurance company payment from the insured's income] is that the deemed payment by the insured is treated as a capital expenditure by the insured that is instantly offset against the deemed receipt by the insured of the economic benefit of having a liability satisfied." *Id.* at 339 (emphasis added). Professor Dodge does not offer any explanation as to why the payment by the insured would be a capital expenditure. Indeed, he does not actually claim that it is a capital expenditure. Rather, he asserts that it is being treated as a capital expenditure since that is the only explanation he can envision for the Service's exclusion of the insurance recovery from the insured's income. To the contrary, in this Article, I have put forth a rationale for the exclusion of income that does not rest on the determination that the insured's payment was a capital expenditure or otherwise created basis. Professor Dodge is correct that the "netting [of the insurance proceeds with the payment to the injured party] produces the correct tax outcome," *id.* at 343, but he does not provide any tax policy justification for the creation of the basis and the resulting netting.

68 See Kahn, *supra* note 8, at 668 ("That is not to say that the taxpayer actually has a 'basis.' One can have a basis only in non-cash tangible or intangible property. But, basis is comprised of dollars that have been invested; and so the replacement of dollars is equivalent to a replacement of basis, both of which represent a return of capital.").

69 40 B.T.A. 333 (1939), *acq. in result*, 1957-1 C.B. 3. The Service initially nonacquiesced to *Clark*, 1939-2 C.B. 45, but reversed its position to acquiescence eighteen years later.

70 The Board of Tax Appeals was the predecessor of the current Tax Court.

counsel offered to pay the full difference to the Clarks, which the Clarks accepted.<sup>71</sup>

The Clarks did not report the payment from tax counsel as income on their federal tax return. The Service argued that the amount should have been included. The two sides had simple arguments. The Service argued that the tax counsel essentially paid a tax liability of the Clarks, and thus the Clarks should have included it in income.<sup>72</sup> On the other hand, the Clarks “contend[ed] that this payment constituted compensation for damages or loss caused by the error of tax counsel, and that [they] therefore realized no income from its receipt in 1934.”<sup>73</sup>

The Board of Tax Appeals held for the Clarks. Although the Service acquiesced to the *Clark* decision in 1957, reversing its initial position of nonacquiescence,<sup>74</sup> in recent years the Service has continually attempted to minimize the scope of the *Clark* decision.

In 1992, the Service published Private Letter Ruling (PLR) 92-11-015. The ruling was requested by a mutual fund inquiring into the tax consequences of receiving a reimbursement from the insurance carrier of a certified public accounting (CPA) firm. In three tax years, the fund failed to qualify as a regulated investment company (RIC) on account of negligence by the CPA firm. Due to that failure, the fund was required to file as a C corporation.<sup>75</sup> The failure to qualify as a RIC required the fund to pay more in federal taxes, including penalties and interest, than it would have if it had qualified as a RIC.<sup>76</sup> The CPA firm’s liability insurance company reimbursed the fund for those expenses, and the ruling addressed the issue of whether that reimbursement constituted income to the fund.

In the ruling, the Service stated:

Whether the reimbursement is includible in Fund’s gross income under section 61(a) of the Code depends on the nature of the recovery. Specifically, if the reimbursement is a recovery of lost profits, it is includible in the Fund’s gross income. However, if the reimbursement is a replacement of Fund’s capital, it is not includible in Fund’s gross income. . . . Payment by the one causing a loss that does no more than restore a taxpayer to the position he or she was in before the loss was incurred is not includible in gross income because there is no economic gain.<sup>77</sup>

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71 *Clark*, 40 B.T.A. at 334.

72 The Service specifically cited *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), which held that when an employer pays the income tax owed by an employee, the employee has income. *Clark*, 40 B.T.A. at 335.

73 *Clark*, 40 B.T.A. at 335.

74 1957-1 C.B. 4; *see also* Rev. Rul. 57-47, 1957-1 C.B. 23.

75 A C corporation is a corporation that is not taxed under Subchapter S. I.R.C. § 1361(a)(2) (2000).

76 The fund incurred legal, accounting, and bank line-of-credit fees which were also reimbursed by the CPA firm’s insurance company. I.R.S. Priv. Ltr. Rul. 92-11-015 (Dec. 12, 1991).

77 *Id.*

The Service, citing *Clark*, ruled that in the fund's case, the reimbursement should be considered a nontaxable return of capital.<sup>78</sup>

However, in 1997 the Service reversed its position. In PLR 97-43-035, the Service specifically revoked PLR 92-11-015 because "it is not in accord with the current views of the Service."<sup>79</sup> The Service attempted to distinguish *Clark* and the facts of a previously published ruling by stating:

In *Clark* and Rev. Rul. 57-47, the preparers' errors in filing returns or claiming refunds caused the taxpayers to pay more than their minimum proper federal income tax liabilities based on the underlying transactions for the years in question. In this case, however, the CPA firm's error altered the underlying entity status of the Fund. Fund incurred the minimum proper federal income liability as a subchapter C corporation during the period it did not qualify as a RIC. The CPA firm's reimbursement, unlike the reimbursements in *Clark* and Rev. Rul. 57-47, was not made to compensate Fund for a tax liability in excess of Fund's proper federal tax liability for the tax years relating to the firm's negligence. Instead, the reimbursement was a payment of Fund's proper tax liability.<sup>80</sup>

The Service, however, has not had much litigating success, and rightfully so, with its attempt to apply *Clark* so narrowly. For example, *Concord Instruments Corporation v. Commissioner*<sup>81</sup> involved a taxpayer that had lost an earlier tax court decision which increased its tax liability by \$160,020. The taxpayer had the right to appeal that decision, but its attorney failed to file a timely notice of appeal. The taxpayer filed a claim against its counsel's liability insurance on account of not filing the notice. The two parties settled the claim, and the insurance company paid \$125,000 to the taxpayer. The taxpayer did not report this amount as income, a position with which the Service disagreed.

The taxpayer cited *Clark* in support of his position that the reimbursement was a nontaxable return of capital. In the words of the court, the Service attempted

to distinguish *Clark* on the grounds that in *Clark* the attorney's error undisputedly caused the taxpayer to pay more taxes. The essence of respondent's argument is that any error by petitioner's counsel was harmless because petitioner's case was correctly decided by the Tax Court. Under that assumption, any funds petitioner received were an economic benefit and not compensation for injury.<sup>82</sup>

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78 *Id.* The Service noted that some of the reimbursement could be taxable to the fund to the extent that the fund was reimbursed for deductible expenses that had provided a tax benefit.

79 I.R.S. Priv. Ltr. Rul. 97-43-035 (July 28, 1997).

80 *Id.*; see also I.R.S. Priv. Ltr. Rul. 98-33-007 (May 13, 1998) ("[Y]our payment of additional federal income tax was not due to an error made by the attorneys on the return itself but on an omission to provide advice that would have reduced your federal income tax liability. Thus, unlike the situations in *Clark* and Rev. Rul. 57-47, you are not paying more than your minimum proper federal income tax liability based on the transaction for the tax year to which the tax reimbursement relates.").

81 67 T.C.M. (CCH) 3036 (1994).

82 *Id.* at 3041-44.

The court disagreed with the Service and held the amount nontaxable. Basically, the court held that the amount represented a return of capital similar to the amount paid to the Clarks. The fact that the two parties agreed that \$125,000 represented the amount of “damage” caused by the attorney’s mistake should be respected by the Service.<sup>83</sup>

More recently, the issue arose in a contract action by Centex Corporation against the United States government.<sup>84</sup> Centex Corporation purchased certain assets from the Federal Savings and Loan Insurance Corporation because of the promise that specified tax benefits were tied to those assets. A few years later, Congress passed legislation, with a retroactive effective date, that disallowed those tax benefits. Because of the loss of the benefits, Centex was required to pay additional federal taxes.

Centex sued the government for breach of contract in the amount of the lost tax savings from the retroactive legislation. The court held for Centex in the case and ruled that Centex paid approximately \$55 million more than it would have paid if the tax benefits had not been withdrawn.

Centex urged that the damage amount should be increased to account for the fact that the recovery could be taxable to them. It is an interesting twist that, in this circumstance, the government, citing *Clark*, argued that the amount would not be taxable and thus no gross-up was required.

The court agreed with the government on the gross-up issue. The court stated:

The judgment is not a replacement of lost income. Instead, plaintiffs are receiving monies already subject to tax once before. Indeed the entire point of the breach claim is that the judgment represents tax or penalties that, but for the breach of contract, would not have been paid. The money that the plaintiffs would have saved in the absence of a breach had, by definition, already been taken into account for tax purposes. It follows that an award from this court to compensate plaintiffs for the loss of that money is not subject to income tax. It represents income already taxed.<sup>85</sup>

Generally, I agree with the reasoning of *Clark*. The Service’s attempts to limit the holding of *Clark* rightfully have been dismissed by the courts. As discussed below, the *Clark* reasoning plays an important part in the discussion of the appropriate tax treatment of tax insurance.

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83 See Kahn, *supra* note 8, at 669 (“In my view, however, whatever figure the taxpayer and the attorney’s insurer agree upon . . . should be accepted by the Service because it will be the product of an arm’s-length agreement. There is no risk of collusion in this circumstance, and the bona fides of such an agreement are beyond question since the insurer has no extrinsic motives . . . for settling the issue.”).

84 Centex Corp. v. United States, 55 Fed. Cl. 381 (2003).

85 *Id.* at 389.

### III. Treatment of Tax Insurance Receipts

#### A. *The Exclusion of Tax Insurance Receipts from Income*

It appears that commentators and the insurance industry have taken the view that tax insurance proceeds are taxable to the insured.<sup>86</sup> Contrary to the majority view, I believe that such payments are nontaxable. The receipt of a payment from an insurer for a portion of income taxes paid by the insured pursuant to a tax insurance contract should be given the same tax treatment as is accorded to insurance proceeds paid to reimburse the insured for damages owed to a victim of the insured's negligence, and for the same reasons. The purchase of tax insurance for a fee shifts the primary risk of a larger tax liability from the insured to the insurer. If the insured's tax liability is greater than the amount listed in the contract, it becomes a liability of the insurer. Between the government and the insured, the insured is liable to the government for the taxes. But this situation is the same as the case of a liability owed by an insured to a third party for injuries caused by the insured's negligence. Between the insured and the third party, the insured is liable to the third party. The ultimate liability for the obligation to a victim or to the Service, however, lies with the insurer in both cases.

By contract, the ultimate obligor for the tax is the insurer. The insurer's payment to the insured is merely the circular means by which the insured bore that obligation. The insured does not recognize income, because the payment under the tax insurance contract replaces dollars that the insured paid to the Service. As noted above, the replacement of dollars spent is equivalent to the replacement of basis.

Essentially, this situation is similar to the facts of *Clark* and should follow the same reasoning. That is, an insurance company is not paying the insured's tax liability; it is reimbursing dollars spent by the insured and thus the reimbursement should be treated as a return of capital. The difference between the tax insurance situation and the *Clark* line of cases in which a tax advisor, lawyer, or accountant makes a mistake is that the insurance company does not cause the "loss" in the tax insurance situation. Instead, the insured pays the insurance company to accept the risk that the Service may impose a greater tax.

The issue, then, is whether this difference suggests a policy justification for a different tax result. The comparison to liability insurance is useful. The insured pays a company to accept a possible future liability due to the insured's

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<sup>86</sup> See, e.g., Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income*, 46 TAX L. REV. 381, 398 n.81 (1991) ("It is clear that any tax audit insurance payments received by a taxpayer should be taxable under *Old Colony*. Since the tax liability determined on audit is the correct liability based on the nontax facts, the taxes for which the taxpayer is reimbursed cannot be characterized as a *Clark*-type excess tax loss."); see also Logue, *supra* note 2, at 388; *supra* note 44 and accompanying text.

actions. When the insurer is required to pay under the insurance contract, the insured does not realize income. It does not matter that the insurance company is not the party responsible for the loss.

The tax insurance contract is an arm's-length commercial arrangement in which a risk or potential liability is shifted from one party to another who is paid for undertaking the ultimate liability for that risk. Just as one can sell the right to income, and thereby dispose of the tax liability for the subsequent receipt of that income, so should one be able to transfer a potential liability by paying another a fair fee for taking it over. In this regard, an insurer's satisfaction of an insured's tax liability is no different in principle from satisfying an insured's tort liability. The uncertainties of tax application, due to the complexity of the tax system, make predicting how a transaction will be taxed as speculative as is predicting the prospect of incurring a tort liability.

The tax insurance situation is distinguishable from the *Old Colony*<sup>87</sup> case, in which an employer agreed to pay the income taxes incurred by an employee's receipt of salary from the employer. The employer's agreement to pay those taxes was made as compensation for the employee's services and constituted additional compensation to the employee. The additional compensation was properly held by the Supreme Court to be income to the employee.

One potential objection to not taxing reimbursements under tax insurance is that the anticipation of income doctrine applies only to the sale of possible gains, and the rationale for that concept should not be extended to permit the transfer of potential losses. Congress has demonstrated that it wishes to prevent the transferring of a deduction from one taxpayer to another. For example, in the situation where a person makes a gift of property, the donee's basis in the gift is determined by reference to the donor's basis at the time of the gift.<sup>88</sup> However, if the fair market value of the gift is less than the donor's basis at the time of the gift (that is, if the property is a depreciated asset), then for loss purposes the donee's basis is that lower fair market value.<sup>89</sup> The purpose of this fair market value limitation to the transferor basis rule appears to be that Congress desires to prevent taxpayers from transferring built-in losses and thereby potentially transferring a deduction to a taxpayer in a higher bracket.<sup>90</sup> Could the same concern apply to tax insurance?

The comparison to the treatment of gifts of depreciated property is inappropriate. The limitation on the basis rules for gifts is in place to block the transfer of accrued *deductible* losses from one party to another. That is, the Service does not look kindly on taxpayers transferring a built-in loss that has

87 *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929).

88 I.R.C. § 1015(a) (2000).

89 *Id.*

90 *See S. REP. NO. 558*, at 33 (1934), *as reprinted in* 1939-1 C.B. 586, 611-12.

already occurred from one taxpayer to another. This rule is merely one aspect of the congressional effort to prevent parties from trading in deductions.<sup>91</sup> Tax insurance is entirely different. In the tax insurance situation, no built-in tax deductions or losses are shifted from one person to another. What is transferred is not a loss that has already occurred, but rather the risk of incurring future losses. If the loss actually occurs, it arises during the period in which the insurer primarily bears the risk—that is, the loss arises at a time when the insurer is the one who is primarily responsible for it.<sup>92</sup> The concern behind the limitation on basis for gifts does not apply in the tax insurance case and thus is not relevant to the determination of how those insurance proceeds should be treated.

In the case of tax insurance, the premium paid to the insurer represents a cost to the insured. The dollar loss suffered by the insurer from accepting the risk is the difference between the entire amount paid by the insurer (reduced for income tax savings arising from the deduction of that payment) and the premium it received from the insured. However, the premium paid by the insured is not a prepayment of a portion of the tax liability because it is payable regardless of whether the insured incurs any additional liability. The premium is a fee for shifting the risk to the insurer.

#### B. *Tax Insurance as Tax Abuse?*

If the Service allows tax-free treatment for tax insurance receipts, is there a potential for taxpayers to abuse the system to reach results inconsistent with tax policy and specific rules? Professor Zelenak, in his article on tax indemnity payments, raised that concern and used it to justify his conclusion that such payments should be taxable to the recipient.<sup>93</sup>

Consider the following example drawn from Professor Zelenak's article. *A* wishes to sell his bond to *B*, and the bond will pay \$100 on maturity. *B* is willing to purchase the bond for \$100 if it will provide *B* with a 10% return after taxes. Assume *B* is taxed on all income at a 20% rate. If the interest on the bond were taxable, *A* would be required to pay a 12.5% interest rate to provide *B* with the 10% after-tax return.<sup>94</sup>

Instead, *A* issues the bond to *B* but promises (erroneously) that the interest on the bond will be tax-free. Later, *B* demands that *A* reimburse him for the \$2

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91 See, e.g., I.R.C. §§ 269, 382, 482 (2000 & Supp. 2005).

92 In the gift situation, a donee is allowed to deduct a loss that occurs while the donee held the gifted property. For example, assume *A* gifts Blackacre to *B*. *A*'s basis in Blackacre is \$5,000 and the fair market value of Blackacre at the time of the gift is \$2,000. *B* later sells Blackacre to *C*, an unrelated person, for \$1,000. While Code § 1015(a) disallows *B* from deducting the \$3,000 loss that occurred while *A* held Blackacre, *B* will be allowed to deduct the loss of \$1,000 that occurred while *B* held Blackacre.

93 Zelenak, *supra* note 86, at 398-99.

94  $12.5 \times 20\% = 2.5$ . Thus, *B*'s after tax return would be  $12.5 - 2.5 = 10$ , or 10% of \$100.

tax paid to get *B* to the desired after-tax return rate. If the reimbursement is excluded from *B*'s income, *B* will receive the desired 10% after-tax return and it will only have cost *A* \$12, or 12% of the bond, to achieve it. As noted by Professor Zelenak, this reduces the cost to *A*, because if the parties had agreed that it would be taxable from the beginning, *A* would have been required to pay \$12.50 interest, or 12.5%.<sup>95</sup>

If the \$2 is taxable to *B*, then *A* would be required to pay *B* \$2.50 to get *B* to the desired after-tax result. Thus, *A* would be required to pay a total of \$12.50, the same amount that *A* would have been required to pay if it was acknowledged from the beginning that the interest would be taxable.<sup>96</sup> As shown below, when analyzed properly, regardless of whether tax insurance is excluded from income, the \$2 payable by *A* is taxable to *B*.

While Professor Zelenak's example makes an interesting point, the validity of his conclusion that resolution of his example requires that tax insurance proceeds be taxable is doubtful. The problem he describes does not exist in the case of a commercial insurer who is seeking profit on relieving an insured of risk. The insurer has no motivation to insure an unrealistic tax goal to provide the insured with a tax benefit or to induce the insured to engage in a proposed transaction. Even if the payments made by *A* in the bond illustration were held to be excluded from income, that situation has no bearing on the proper tax treatment of tax insurance provided by a third party that has no other interest in the transaction.

Moreover, even if, as I advocate, tax insurance payments from a third party are excluded from income, and even in the unlikely event that the guaranty of tax exclusion that *A* gave to *B* in Professor Zelenak's bond example were found to be bona fide, the payments that *A* made to *B* in that example should be included in *B*'s gross income. *A* is not merely an insurer of *B*'s tax treatment. *A* is also a borrower<sup>97</sup> whose undertaking of an insurance role is inextricably connected to his position as a borrower. The loan and the warranty of tax treatment are so intertwined that one cannot be separated from the other. In substance, *A* has agreed to pay additional interest equal to any higher tax that *B* might be required to pay. Regardless of how the parties might seek to characterize them, the payments should be treated as variable interest on that debt. Obviously, the variable interest payments are included in *B*'s gross income. Consequently, there is no tax abuse in this situation.

The proper treatment of tax guaranties by a seller of a product is discussed in Part IV below. Part IV also contains further discussion of the proper treatment of the bond example.

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95 Zelenak, *supra* note 86, at 399.

96 *Id.*

97 *A*'s receipt of \$100 from *B* is a loan to *A* on which interest is payable. The bond is a debt instrument that shows the amount that the borrower, *A*, owes to the lender, *B*.

Unless and until such unforeseen abuses actually become prevalent, it is reasonable to leave their prevention to the operation of the substance versus form doctrine under which the bona fides of a transaction can be challenged.

### C. *Tax Treatment of Premium Payments*

Should the question of how the insured treats the premium payment for tax purposes affect the insured's tax results when an insurer pays the additional tax liability? In my opinion, the issue of the deductibility of the insurance premiums should have no bearing on the ultimate determination of the correct tax results for the insurer's payment. Similarly, the fact that the insurer's satisfaction of tax liability is nontaxable to the insured should not dictate that the premium payment is nondeductible, although this question may require further exploration. At first glance, this treatment may seem inconsistent, perhaps even whipsawing the Service.<sup>98</sup> Still, there are other situations that produce comparable tax results. For example, when a business purchases general liability insurance, the premiums are deductible to the business despite the fact that should the insurance company cover a future liability under the insurance contract, the insured does not have income.

Concluding that the tax treatment for one issue (the taxation of the tax insurance proceeds) is not determinative of the other issue (the deductibility of the premiums) does not answer the question of what the appropriate tax treatment is for the insured's payment of the premiums. Although it is a close question, and a strong case can be made that Congress should adopt a provision denying a deduction on policy grounds, I conclude that such payments should be deductible by the insured under Code § 162 as currently written.<sup>99</sup>

Initially, the issue appears fairly straightforward. Paying the insurance premium is an ordinary and necessary business expense of the company and

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98 Note that Code § 265(a)(1) does not apply to the tax insurance premiums. Code § 265 states that no deduction shall be allowed for "[a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle . . . ." This provision generally disallows deduction for life insurance premiums. BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 11.10. However, the object of Code § 265(a)(1) is the situation where an item of income is excluded from taxable income by a tax provision. Congress does not wish both to exclude an item from taxable income and also allow a deduction for expenses incurred in producing that income. The provision is aimed at preventing a double tax benefit. There is no reason to apply the provision to expenses that produce an item which simply is not income as distinguished from an item of income which is excluded from taxable income by a tax provision. For example, the provision has not been applied to general liability insurance premiums, probably because those proceeds are not an item that is excluded or deferred from income by any tax provision (unlike proceeds from life insurance, which are exempted from income by Code § 101) but rather are simply not treated as income at all. The same reasoning should apply to tax insurance premiums, and thus Code § 265 should not bar a deduction for such premiums.

99 Code § 162 states, "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162 (2000 & Supp. 2005).

therefore is deductible under Code § 162.<sup>100</sup> As noted above, companies deduct insurance premiums when they buy general liability insurance, and the tax insurance premium should not be treated differently.

Admittedly, there is a significant difference between general liability insurance and tax insurance with regard to this issue. If a company had actually paid damages instead of the insurance company's covering the payment, the company payment would be deductible as a valid business expense. In contrast, if the company had actually paid the additional tax liability, it would not be permitted to deduct the cost of that payment.<sup>101</sup>

Does that difference require the conclusion that payment of the tax insurance premium is nondeductible? The premium is not a prepayment of tax liability. Instead the premium represents a genuine, ordinary and necessary business expense and thus should be deductible under Code § 162.<sup>102</sup> While the present value of the tax liability payment is one of the elements used to determine the premium charge, the payment represents the fair price of transferring a business risk to an independent third party, similar to the premium for liability insurance. The fact that the premium is a cost that the insured incurs regardless of whether the insured incurs any additional tax liability evidences that the premium is not a prepayment of a tax.

Why is a premium a business expense? One reason for acquiring tax insurance is that the desirability of entering a business transaction may depend upon how it will be treated by tax law: the taxpayer may not be willing to risk suffering the business loss he will incur if an adverse tax treatment is imposed. The premium then can be viewed as an expense of conducting a business transaction.<sup>103</sup>

This conclusion becomes clearer when one focuses on the arrangement from the perspective of the insurance company. What are the tax consequences to the insurance company when it pays the insured's additional tax liability? As noted above, the payment of federal income tax is a nondeductible expense.<sup>104</sup> However, the insurance company is not paying its own federal taxes; it is covering a liability that it assumed as a business risk. Thus, the payment would be deductible by the insurance company. Compare this tax treatment to the tax results involving general liability insurance payments. When an insurance company pays for damage caused by a client acting in a personal, nonbusiness

100 *Id.*

101 *See* I.R.C. § 164(a) (2000).

102 *See supra* note 99.

103 Depending on the type of transaction being insured, however, the cost of the insurance may be required to be capitalized as part of the cost of an acquisition of a business or specific assets. *See* BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 12.04 (stating that expenditures in investigating a potential acquisition, as well as commissions, legal fees, and other expenses incurred in consummating the transaction are also capital expenditures includable in the cost basis of the acquired assets, rather than deductible expenses under Code §§ 162 or 212).

104 *See* BITTKER, MCMAHON & ZELENAK, *supra* note 44, ¶ 12.04.

capacity, the insurance company still takes a deduction for paying the liability even though the loss would not have been deductible by the insured if he had to pay the damages.<sup>105</sup> Covering losses is the business of the insurance company, and it does not matter to the insurance company whether the payment would be deductible by the insured or not.

It might appear that this conclusion could lead to abuse. Taken to its extreme, a business could use this reasoning to convert a nondeductible expense into a deductible one. For example, a business could pay an insurance company to assume the “risk” of its future tax liability in a situation where there is very little doubt, if any, of what that liability will be. Thus, the premium would be very close to the amount of the actual liability. Under the above reasoning, the business could deduct the cost of the premium and the insurance company could deduct the cost of paying the tax. Thus, the business would be able to convert the federal tax liability payment into a deductible expense.

This example is clearly distinguishable from the legitimate tax insurance premium that involves a true shifting of a risk. Using a general substance over form argument, the Service should be able to recharacterize the purported insurance premium as the actual payment of the federal tax liability and thereby disallow any deduction for it. A similar line of argument worked for the Service in *Helvering v. Le Gierse*.<sup>106</sup>

In *Le Gierse*, the issue was whether proceeds from a contract qualified as “insurance” proceeds.<sup>107</sup> If so, the proceeds would have been excluded from the decedent’s gross estate under a then-existing statute exempting \$40,000 of life insurance proceeds.<sup>108</sup> Shortly before her death, the decedent purchased two contracts from the Connecticut General Life Insurance Company and prepaid the entire premiums for both. One contract was an annuity entitling the decedent to approximately \$590 per year as long as she lived. The cost of the annuity was \$4,179. The other contract was a life insurance policy that provided for a \$25,000 payment to the decedent’s daughter. The premium for the life insurance contract was \$22,946. At the time that she executed the two contracts and prepaid the premiums, the decedent was eighty years old.<sup>109</sup> The subsequent annuity payments to be made to the insured would be offset by the income earned on the insurance company’s investment of the prepaid premiums. So the only risk that the insurer would ever have less than \$25,000

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105 I.R.C. § 165(a)(1)-(2) (2000). The one exception for the nondeduction of personal losses is the loss deduction allowed under Code §§ 165(c)(3) and (h) for casualty and theft losses. Those deductions do not apply to liability damage payments by a tortfeasor.

106 312 U.S. 531 (1940).

107 *Id.* at 537.

108 Revenue Act of 1926, ch. 27, § 302(g), I.R.C. § 811(g) (1940) (amended 1942, removing \$40,000 exclusion); see *Le Gierse*, 312 U.S. at 537-38.

109 *Le Gierse*, 312 U.S. at 536-37.

in hand was an investment risk as to the amount of income that was earned from investing the prepaid premiums.

The Court held that “[h]istorically and commonly insurance involves risk-shifting and risk-distributing.”<sup>110</sup> Since the decedent could not have acquired the insurance policy without also purchasing the annuity, the Court considered the two together. The Court determined that no actual risk had been shifted from the decedent to the insurance company, and thus the \$25,000 payment on the insured’s death did not qualify as insurance proceeds. As such, the proceeds were not excluded from the decedent’s estate.

This type of analysis has been used by other courts to determine whether an instrument should be classified as insurance.<sup>111</sup> Using this same analysis, if there has been no shifting of any significant risk, the coverage should not qualify as insurance, and the payment should be viewed instead as an actual nondeductible payment of the tax liability, using the insurer as an agent to transmit the payment to the Service.

One objection to permitting both a deduction for tax insurance premiums as well as excluding the insurance proceeds from income is that the combination of tax treatments makes the purchase of tax insurance more attractive than it otherwise would be. Consider whether, in principle, that consequence differentiates tax insurance premiums from other deductible items. For this purpose, assume that the tax insurance proceeds will be excluded from income, as I concluded earlier in this Article.

How will the insurer determine the amount to charge as a premium for tax insurance? The insurer will have made an evaluation of how much tax is at risk and the likelihood that the tax will be imposed. That likelihood can be represented by a percentage figure, which is little more than an educated guess.<sup>112</sup> For example, assume *X* Corporation wishes to engage in a transaction that it believes will produce \$1.0 million of revenue. The insurer estimates that there is a 25% chance that a 35% tax will be imposed on that \$1.0 million and a 75% chance that the \$1.0 million will not be taxed at all. Applying these figures, the value of the pure risk that a 35% tax will be imposed is \$87,500.<sup>113</sup>

The premium must cover more than the value of the risk. The insurer must include in the premium an amount to pay for the clerical and administrative expenses in issuing, overseeing, and making payment on the policy. In

110 *Id.* at 539.

111 See Donald Arthur Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RES. L. REV. 79, 96 (1990) (“The courts have followed this analysis and found the absence of insurance where the company in question did not assume an underwriting or economic risk. In addition, the risk must be substantial.”).

112 See Sarah B. Lawsky, *Probably? Understanding Tax Law’s Uncertainty*, 157 U. PA. L. REV. (forthcoming Apr. 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1161319](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1161319).

113  $(25\% \times \$350,000) + (75\% \times 0) = \$87,500$ .

addition, the insurer will include an amount to provide it with a profit. Once that figure is determined, the insurer likely will discount it to reflect that the insurer's payment on the policy will be deductible, reducing the insurer's tax liability. That discount may well reduce the premium to a figure that is less than the value of the taxpayer's risk. Let us assume that the insurer has determined that it needs to add \$15,000 to the premium to pay for its costs and provide a meaningful profit. That figure will be added to the value of the risk undertaken, which is \$87,500. The \$87,500 figure arose from multiplying the tax that would be due (\$350,000) times the 25% estimated risk of occurrence. However, if the insurer is required to pay the \$350,000 tax, it will be allowed a deduction for that payment. If we assume that the insurer will be in a 35% income tax bracket, the after-tax cost to the insurer for making that payment is \$227,500.<sup>114</sup> The risk to the insurer then is 25% times \$227,500, or \$56,875. The premium then will be \$56,875 plus \$15,000 (the cost of administration plus profit), or \$71,875. It is significant that, because of the discount, the premium charged for the tax insurance can be less than the value of the risk that the insured is shifting to the insurer.

One objection to permitting a deduction for tax insurance premiums is that the deduction makes the purchase of tax insurance more attractive than it otherwise would be. In other words, the deduction creates a market inefficiency, because more taxpayers will purchase the insurance than if no tax deduction were allowable. Indeed, if a deduction is allowed, the after-tax cost of the premium can be significantly less than the value of the risk that the insured is shifting to the insurer. The nominal premium itself may already be less than the value of the risk, since the insurer will have discounted it to reflect the fact that any distribution under the policy will be deductible by the insurer.

One response to this objection is that a distortion of the market is not particular to the purchase of tax insurance. The existence of an income tax system necessarily creates market distortions. The allowance of a tax deduction for an expense will reduce the cost of that expense and thereby distort the market decision as to whether to incur the expense. For example, the allowance of a deduction for entertainment and travel expenses influences the decision to engage in such activities and the amount expended on them.<sup>115</sup> It is not possible to eliminate all of the market distortions caused by the tax system. In those cases in which the market distortion is deemed especially undesirable because it conflicts with social or economic policies, Congress will modify a provision. These modifications occur only in special circumstances. For example, Code § 132(f)(4) prevents the application of the constructive receipt doctrine when an employee has the option of choosing between accepting a qualified

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114  $\$350,000 \times 65\%$ .

115 See, e.g., I U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 84-85 (1984) (stating that proposals to limit deductions for business meals and entertainment expenses will reduce demand for expensive meals and various forms of entertainment).

transportation fringe benefit or cash compensation. To deter the offering of that choice would encourage more employees to drive to work, which conflicts with environmental concerns.<sup>116</sup>

Does the fact that allowing deductions for tax insurance premiums encourages purchasing this insurance require that no deduction be allowed? There is no policy reason to consider the purchase of tax insurance to be harmful to the public, and so its purchase should not be discouraged. To the contrary, the purchase of tax insurance can facilitate the engagement of investments that are beneficial to society and should perhaps be encouraged.

Rejecting tax insurance premium deductions would have to rest on the determination that the resulting encouragement to the decision to purchase such insurance conflicts with some non-tax policy. The determination of whether such a conflicting policy exists and whether it is of sufficient concern to warrant changing the tax law should be left to Congress. In my view, the purchase of tax insurance is beneficial to society and does not contravene any non-tax policies.

#### IV. Seller's Guaranty of Income Tax Treatment

##### A. *In General*

To induce a buyer to purchase an investment, a seller may guaranty the buyer that the tax treatment of the investment will accord with a specified prediction. If the investor's tax liability is greater than the guaranteed amount, and the seller pays the difference to the buyer, how should the Service treat these payments for tax purposes?

Part of the nominal purchase price for the investment can be seen as a payment for the transfer of the tax risk from the buyer to the seller. In that respect, the situation appears to be the same as the one described above for the purchase of tax insurance from a commercial insurer, and one might expect the tax treatment to be the same. There is, however, a countervailing consideration in this case that leads to an entirely different tax result.

The guaranty by the seller is not made independently of his role as a seller of a product. As noted above in discussing the bond example of Professor Zelenak, the seller's role as an insurer is inexorably bound to his role as a seller. Any payments made by the seller pursuant to that guaranty should be treated as a reduction of the purchase price paid by the buyer rather than as insurance proceeds. While the payments would nevertheless not be taxable to the buyer, they would reduce the buyer's basis in his investment. The payments

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116 See S. Rep. No. 105-33, at 198 (1997) (“[T]he election to take cash may promote sound energy policy by increasing the use of mass transit and reduce the amount of commuting by car.”).

should not be treated as a reimbursement of the taxes paid by the buyer (an insurance or *Clark*-type treatment), but rather should be treated as a reduction of the purchase price. In the unlikely circumstance that the payments under the guaranty should exceed the purchase price, that excess should be income to the buyer. It is windfall income and is taxable.

Consider the comparable situation that arises on the cancellation of debt. *G* purchases a building from *K* for \$500,000. *G* pays *K* \$100,000 and gives *K* his promissory note, bearing adequate interest, in the amount of \$400,000, secured by the building. Subsequently, because of *G*'s financial difficulties (although assume *G* is not insolvent), *K* agrees to cancel \$50,000 of the debt and accepts a new note from *G* for \$350,000 in substitution of the old \$400,000 note. The common law treatment of cancelling \$50,000 of *G*'s debt was that it was not income to *G*, but rather constituted a reduction of his purchase price for the building to \$450,000. Congress codified that result in Code § 108(e)(5). The underlying rationale for this treatment is that *K*'s role as a creditor cannot be separated from *K*'s role as a seller. So, when *K* cancels \$50,000 of *G*'s debt, he effectively is reducing the selling price of the building. The same tax treatment should be accorded a payment made by *K* pursuant to a guaranty of any nature, including a guaranty of tax consequences.

Consider the very different tax consequence if *G* had financed the purchase of the building by obtaining a loan from the Friendly Bank for \$400,000, secured by the building, instead of obtaining a purchase money loan from *K*. If the Bank subsequently forgave \$50,000 of the \$400,000 debt owed by *G*, the forgiveness could not be viewed as a reduction of the purchase price, since the Bank is not the seller.<sup>117</sup> Consequently, unless *G* was insolvent, the \$50,000 cancellation of the debt would be included in *G*'s gross income.<sup>118</sup>

In sum, it is my view that payments made by a seller pursuant to a tax guaranty should be treated not as insurance proceeds, but rather as a reduction of the purchase price.

How, then, does this conclusion apply to Professor Zelenak's bond example discussed in Part III? In that illustration, the payments made by *A* pursuant to the guaranty appear more as variable interest on the bond rather than as a reduction of the price paid for the bond. It is a factual issue, but making payments periodically as each year's tax bill becomes due has all the characteristics of interest payments, rather than those of periodic reductions of the purchase price. But what if the payments are treated as reductions of the purchase price? What would be the tax consequence of that treatment?

If the payments under the guaranty are treated as a reduction of *B*'s purchase price for the bond, the payments would be treated as a return of *B*'s

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117 See Rev. Rul. 92-99, 1992-2 C.B. 35. *But see* Freedom Newspapers, Inc. v. Comm'r, 36 T.C.M. (CCH) 1755 (1977).

118 *Cf.* Preslar v. Comm'r, 167 F.3d 1323 (10th Cir. 1999) (stating that forgiveness of loan could not be nontaxable purchase-price adjustment since the bank was not the seller of the property).

capital and so would not be taxed to him. Since it is not taxable, does that mean that the result of this characterization is the same as the one described by Professor Zelenak, which resulted in a tax abuse? The answer is that a reduction of purchase price has very different tax consequences than those that attend a treatment of the payments as tax insurance proceeds. Unlike the insurance or *Clark*-type payment, the return of capital would reduce *B*'s basis in the bond. Thus, in the first year, when the \$2 payment is made to *B*,<sup>119</sup> *B*'s basis in the bond would decrease from \$100 to \$98. The effect of this reduction would be that *B* would recognize a \$2 gain when the bond is redeemed. Each year thereafter, the bond's basis would be reduced another \$2. The reduction of basis will ultimately be taxable to *B*, either as ordinary income on the redemption of the bond or periodically as original issue discount (OID). This may cause headaches for *B* because it will alter the yield of the investment and perhaps subject *B* to the OID provisions.

How can my conclusion that a payment pursuant to a seller's tax guaranty reduces the purchase or investment price be reconciled with the *Clark* decision? If I am correct, why were the payments made by the attorney in *Clark* not treated as a reduction of the attorney's fee? The answer is that *Clark* was a damages case. The attorney made an error that caused injury to the Clarks by causing them to pay higher taxes than would have been required. The attorney reimbursed the Clarks for the injury that the attorney caused regardless of whether the attorney's error gave rise to legal liability. In contrast, the payments made by a seller pursuant to a tax guaranty are not made to reimburse the buyer for some injury that the seller caused. Instead, those payments are made pursuant to a guaranty that was part of the investment contract.

Note that the proper characterization of payments made pursuant to a seller's guaranty has no bearing on the treatment of commercial tax insurance proceeds. Since the tax insurance contract is separate from the actual transaction, the insurer's payment cannot be recharacterized as either additional investment income (such as variable rate interest) or as a reduction of the cost of the investment. The commercial tax insurance policy is not an element of the insured transaction any more than *G*'s mortgage debt to the Friendly Bank in the illustration above is connected to the actual purchase price of the building.

Given that a tax payment by a seller pursuant to a guaranty will reduce the purchase price, there does not appear to be any tax benefit for the buyer and seller to conspire by purporting to include a guaranty in the sale. In effect, the buyer would pay a higher nominal price, the excess of which will be returned to him periodically. There is no reason, then, to tax such payments to prevent the potential for collusive arrangements when there is no tax advantage to be gained from those arrangements.

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119 In Professor Zelenak's illustration, the additional tax payable each year on the interest from the bond was \$2. Zelenak, *supra* note 86, at 399.

### B. *Specific Treatment of Old Market "Insurance"*

What does this analysis tell us about the taxation of old market tax indemnity arrangements? The discussion above is applicable to all three types of old market tax indemnity vehicles: (1) tax return preparers' warranties; (2) warranties by tax advisors; and (3) standard tax indemnity agreements between purchasers and sellers.

First, consider the treatment of a warranty by a tax return preparer. As noted above, tax return preparers often indemnify clients for any interest or penalty imposed by the Service that is caused by an error of the tax return preparer. If the tax return preparer reimburses a client under such a warranty, what is the tax treatment? Initially, one is tempted to deal with the tax treatment of the warranty payment similarly to the treatment of a seller's guaranty discussed above. That is, the warranty insurance is an integral part of the package offered by the tax return preparer, and thus the payment could be viewed as a refund of the fee charged for the tax preparation service.

On the other hand, the warranty payment is similar for tax purposes to the payment made in *Clark*. That is, the tax return preparer reimburses the taxpayer for an expense that the taxpayer would not otherwise have incurred except for a mistake by the preparer. The payment is a form of damages. Even if the error would not cause a liability in the absence of a warranty, the payment is made to replace a loss that was caused by the tax preparer's error. Thus, the *Clark* reasoning should apply and the payment should be considered a nontaxable return of capital.

Does it make a difference for tax purposes whether the payment is treated as a recovery of capital under the reasoning of *Clark* or as a refund of the preparation fee? Initially, the tax results appear similar, since both lead to the result that the payment is merely a recovery of capital and therefore not taxable. However, there are two important differences. First, if the payment is considered a refund of the service charge, the exclusion would apply only up to the amount of the preparation charge. Any payment in excess of the service fee would be income to the taxpayer. It is possible, depending on the severity of the mistake, that the warranty payment could exceed the tax return preparation fee. On the other hand, if the warranty payment is viewed as the payment in *Clark*, the payment cannot exceed the amount paid out since the tax return preparer is reimbursing the taxpayer for money paid to the Service. Thus, the taxpayer will not have any income from the payment.

Second, if the payment is considered a refund of the tax preparation fee, the tax benefit rule could require the taxpayer to include the entire warranty reimbursement in income. Tax preparation fees are deductible under Code § 212(3). If the taxpayer had taken a deduction for the fees and that deduction provided a tax benefit, then the refund of that amount would require the

taxpayer to recognize income to offset the previous deduction.<sup>120</sup> The tax benefit rule has no bearing if the insurance proceeds are treated as a *Clark* payment since tax liability interest and penalties are not deductible.

This discussion addresses the difficulty of drawing the line between payments that are characterized as a variable return (such as the variable interest in the bond hypothetical) or as a reduction in the cost of the property, and payments that should be characterized under the reasoning of *Clark*. Professor Zelenak argued that *Clark* should apply only when there is a “loss”—when, based on the “nontax facts,” the taxpayer “could not have paid any less tax.”<sup>121</sup> Professor Zelenak’s characterization is similar to the Service’s position and suffers from the same flaws. The *Clark* logic applies whenever the payment reimburses the recipient for additional incurred costs due to an error that the preparer made. The additional costs constitute a “loss” of funds of the recipient, and so the payments are in the nature of damages.

Tax return preparers may also offer audit insurance for an additional fee. Typically, these agreements provide that for a one-time fee, based on the complexity of the tax return, the tax return preparer agrees to represent the taxpayer without charge should the client be audited by the Service. On the one hand, this arrangement appears simply to be a prepayment of a fixed fee for representing the client. However, the payment also has a strong element of insurance. The amount charged by the accountant is usually much less than the value of the services should they be required because the accountant plans to sell the same insurance to a large pool of taxpayers. Thus, the taxpayer is paying the accountant to bear the risk of the taxpayer’s having a controversy with the Service. As with general liability insurance and tax insurance, since the accountant now bears the primary risk, the insured should not have any tax consequence if the taxpayer is audited by the Service and thus has the tax return preparer provide services under the agreement. Similar reasoning applies to medical insurance. That is, a taxpayer does not have income even though the value of medical services received exceeded medical insurance premiums paid. Instead, the medical insurance premium was the price paid by the taxpayer to shift the risk of future medical liabilities to the insurance company.

Different reasoning applies to the warranty agreements provided by tax advisors. The warranty should be considered an integral part of the bargain to return their fee if their advice is faulty, and thus any payment made under that warranty should be considered a refund of the charged fees. Indeed, the arrangement is characterized this way by the parties. A taxpayer should recognize income from such refunds only to the extent that the tax benefit rule

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120 Hillsboro Nat’l Bank v. Comm’r, 460 U.S. 370 (1983); see also I.R.C. § 111 (2000).

121 Zelenak, *supra* note 86, at 398 (“If the tax liability was as low as possible, based on the actual nontax facts, none of the tax should be characterized as a *Clark*-type excess tax loss; without that loss characterization, the cases are governed by *Old Colony* and the payments are taxable.”).

applies or the payment amount exceeds the service charge (because of interest on the fee, for example). The fact that the Service has expressed its hostility toward such refund arrangements through Circular 230 and the list of reportable transactions<sup>122</sup> should have no bearing on the tax treatment of the refund itself. The Service has taken steps to deter abusive transactions, and requiring disclosure of reportable transactions is one method it uses to accomplish that goal. The apparent purpose of the Circular 230 rule, which applies only to advice regarding the taxpayer's original return as contrasted to an amended return, is to deter questionable positions from being taken in the hope that the return will not be audited by the Service—that is, playing the audit lottery.

Finally, as discussed above, the tax treatment of the standard tax indemnity agreement between a purchaser and a seller should be treated as a mere retroactive change in the price of the assets sold.

#### V. Broker's or Agent's Guaranty of Income Tax Treatment

A broker, agent, or similar party<sup>123</sup> can obtain a fee for facilitating the purchase of an investment. Typically, the fee is paid by the seller of the investment. While these agents are not employees of the seller, they do have a financial interest in having the purchase take place. In some cases, in order to induce the investor to make the investment, an agent may guaranty to a potential investor that the investment will yield specified tax consequences. What are the tax consequences of an investor's receipt of a payment from the agent pursuant to that guaranty? Of all the old and new market arrangements, this situation is the most difficult to characterize for tax purposes.

The agent's guaranty was not made in a vacuum. It obviously is connected to the investment and to the agent's fee. But, it is difficult to treat a payment on the guaranty as a reduction of the agent's fee or as a reduction of the investment since the investor did not pay the agent's fee (directly) and the agent did not sell the investment or receive the purchase price. In determining the proper treatment of such payments to the investor, it is helpful to look at an analogous situation that can arise in connection with a cancellation of debt.

As previously noted, if a purchase money debt is reduced, it is treated as the reduction of the purchase price of the property. However, if a third party financed the purchase, the cancellation of any of that debt will not reduce the purchase price and is treated as a cancellation of indebtedness governed by the provisions of Code § 108.<sup>124</sup>

There is one Tax Court memorandum decision that supports the possibility that the payment by the agent might qualify as a reduction of the

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122 See *supra* Part I.A.

123 I will refer to such parties collectively as an "agent."

124 See *Preslar v. Comm'r*, 167 F.3d 1323 (10th Cir. 1999); Rev. Rul. 92-99, 1992-2 C.B. 35.

investment made by the investor. In *Freedom Newspapers, Inc. v. Commissioner*,<sup>125</sup> a broker induced the taxpayer to purchase a package of four newspapers, including one that the taxpayer did not wish to buy, by promising to resell the unwanted newspaper or pay the taxpayer \$100,000 if the broker failed to make that sale. The broker did fail to sell the unwanted paper and so paid the taxpayer \$100,000. The Tax Court held that the broker's guaranty was so tied to the investment of the taxpayer that it had to be included as an integrated element of the transaction. Accordingly, the Tax Court held that the \$100,000 payment that the taxpayer received constituted a reduction of the purchase price for the unwanted newspaper, and so reduced the taxpayer's basis rather than causing income recognition.

The application of the *Freedom Newspapers* holding is likely to be limited to circumstances where the agent who reimbursed the taxpayer played a significant role in the transaction in which the acquisition was made.<sup>126</sup> It is possible that this approach would be applied to an agent's tax guarantee, but then it should apply only up to the amount that the agent was paid to facilitate the transaction.<sup>127</sup>

It also seems incorrect to treat the agent's payment as a payment made pursuant to a tax insurance contract. The guaranty is too closely connected to the investment to be regarded as independent of it. Yet, viscerally, it seems harsh to tax the investor on the receipt of a payment from the agent. Perhaps the apparent inappropriateness of taxing the investor on that amount will lead a court to adopt the approach that the Tax Court took in the *Freedom Newspapers* case as long as the agent played a significant role in the original transaction.

## VI. Conclusion

It is ironic that there is uncertainty about the tax liability attending a product meant to mitigate or eliminate the uncertainty over the ultimate tax treatment that will be applied to a business transaction. This uncertainty has an effect on the number and cost of tax insurance policies issued. This Article explored the question of how tax insurance proceeds should be treated by the

125 36 T.C.M. (CCH) 1755 (1977), *action on dec.*, 1978-62 (Jan. 19, 1978).

126 See I.R.S. Action on Dec. 1978-62 (Jan. 19, 1978) (“[The agent] was intimately involved in the sale of the newspapers . . . [The agent], as the broker negotiating the sale, cannot be viewed as an independent third party to the transaction. The amount of commission [the agent] received on the sale had a direct impact upon the cost to petitioner, hence on his basis in the property.”); see also I.R.S. Priv. Ltr. Rul. 2007-43-003 (July 25, 2007) (“The payment in *Freedom Newspapers* clearly related back to the original purchase of the underlying asset because the payment was made pursuant to an agreement entered into at the time of the purchase, and the taxpayer would not have purchased the asset in the absence of the agreement.”).

127 See I.R.S. Action on Dec. 1978-62 (Jan. 19, 1978) (noting that the agent's commission for the completed sale was in excess of one million dollars).

tax law and how they are likely to be treated. I concluded that there is a strong and valid reason not to tax those proceeds by making an analogy to the anticipation of income doctrine. In addition, when tax insurance is acquired to deal with the tax consequences of a business venture, the premiums payable for that insurance are deductible as business expenses under current tax principles. Accepting these conclusions should lead to the issuance of more tax insurance policies, which could also increase the number of transactions that otherwise would not have occurred because of tax treatment uncertainty.

The importance of resolving tax insurance's tax treatment is not confined solely to the realm of tax insurance, however. I examined several types of tax indemnification arrangements and analyzed how their tax treatment would be affected by the exclusion of tax insurance proceeds. Exploring these related fields provides a richer understanding of the full impact of excluding tax insurance proceeds from income.